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(1)



In the Supreme Court of the United States

OCTOBER TERM, 1946

No. 387

ENSLEY BANK & TRUST COMPANY, PETITIONER

v.

UNITED STATES OF AMERICA

*ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED
STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH
CIRCUIT*

BRIEF FOR THE UNITED STATES IN OPPOSITION

OPINIONS BELOW

The District Court expressed its views in a letter to counsel, which is not contained in the record and which is unreported. The findings of fact and conclusions of law of the District Court (R. 92-110) are unreported. The opinion of the Circuit Court of Appeals (R. 173-177) is reported in 154 F. 2d 968.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered on April 10, 1946. (R. 177.) A

petition for rehearing was denied on May 15, 1946. (R. 181.) The petition for a writ of certiorari was filed on August 12, 1946. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Whether the Circuit Court of Appeals correctly affirmed the holding of the District Court that the taxpayer was not entitled to deductions in its 1933 and 1934 income and excess profits tax returns for a partially worthless debt under Section 23 (j), Revenue Act of 1932, and Section 23 (k), Revenue Act of 1934.

STATUTES AND REGULATIONS INVOLVED

Revenue Act of 1932, c. 209, 47 Stat. 169:

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

* * * * *

(j) *Bad Debts.*—Debts ascertained to be worthless and charged off within the taxable year (or, in the discretion of the Commissioner, a reasonable addition to a reserve for bad debts); and when satisfied that a debt is recoverable only in part, the Commissioner may allow such debt, in an amount not in excess of the part charged off within the taxable year, as a deduction.

* * * * *

The provisions of the above section are continued without substantial change in Section 23 (k) of the Revenue Act of 1934, c. 277, 48 Stat. 680.

Treasury Regulations 77, promulgated under the Revenue Act of 1932:

ART. 191. *Bad debts.* * * *

Where all the surrounding and attending circumstances indicate that a debt is worthless, either wholly or in part, the amount which is worthless and charged off or written down to a nominal amount on the books of the taxpayer shall be allowed as a deduction in computing net income. There should accompany the return a statement showing the propriety of any deduction claimed for bad debts. No deduction shall be allowed for the part of a debt ascertained to be worthless and charged off prior to January 1, 1921, unless and until the debt is ascertained to be totally worthless and is finally charged off or is written down to a nominal amount, or the loss is determined in some manner by a closed and completed transaction. Before a taxpayer may charge off and deduct a debt in part, he must ascertain and be able to demonstrate, with a reasonable degree of certainty, the amount thereof which is uncollectible. Any amount subsequently received on account of a bad debt or on account of a part of such debt previously charged off and al-

lowed as a deduction for income tax purposes, must be included in gross income for the taxable year in which received. In determining whether a debt is worthless in whole or in part the Commissioner will consider all pertinent evidence, including the value of the collateral, if any, securing the debt and the financial condition of the debtor. Partial deductions will be allowed with respect to specific debts only.

* * * * *

Substantially the same provisions are contained in Article 23 (k)-1 of Treasury Regulations 86, promulgated under the Revenue Act of 1934.

STATEMENT

The facts as stipulated (R. 52-62) and as found by the District Court (R. 92-107) may be summarized as follows:

This is an action by Ensley Bank & Trust Company, hereinafter called the taxpayer, for the recovery of \$4,587.65, plus interest, federal income and excess profits taxes for the years 1933 and 1934. (R. 92-93.)¹ During the years here involved, the taxpayer operated on the cash receipts and disbursements basis. (R. 54.)

The taxpayer was incorporated under the laws of Alabama as the Bank of Alabama in 1906, to engage in the general banking business in the En-

¹ The District Court entered judgment in favor of the taxpayer for \$1,760.15 (R. 110), and the Government did not appeal.

sley District, Birmingham, Alabama. The banks in that district depended on the steel business and suffered seriously on account of the 1929 depression. As a result of the depression, the Bank of Alabama, in 1930, disposed of its assets and liabilities but continued its legal existence. (R. 93-94.)

In 1932, because of adverse conditions, it became apparent that the Ensley National Bank of Birmingham, Alabama, hereinafter called "National," could no longer conduct a banking business and it was decided to proceed with a voluntary liquidation of its affairs. On July 18, 1932, National by written contract, appointed the taxpayer as its liquidating agent or trustee, and on October 4, 1932, taxpayer's name was changed from Bank of Alabama to Ensley Bank & Trust Company. From and after July 19, 1932, and throughout 1933 and 1934, taxpayer was engaged in the general banking business in that part of Birmingham known as Ensley. (R. 93, 94.)

Under the original contract of July 18, 1932 (R. 34-44), later superseded by a contract dated February 1, 1933 (R. 13-33), taxpayer agreed to assume and pay off and discharge on demand all of National's debts, liabilities, commitments and obligations, with certain exceptions not material here. National agreed to pay taxpayer the amounts of the liability both thereby or thereafter assumed by taxpayer and in addition to pay

taxpayer at the latter's election as compensation for its services or as interest on the indebtedness assumed, certain specified amounts. Taxpayer was also to be reimbursed for its court costs, and other expenses of liquidation. National's obligation to taxpayer was to mature upon demand by the taxpayer after two years from the effective date of the contract, except that taxpayer could call on National for payment when that was deemed necessary in order that suits could be filed against National's stockholders within the period of the statute of limitations. (R. 94, 95, 96.)

All the assets, business and property of National, except its corporate franchise and its membership in the Federal Reserve system, were to be transferred to taxpayer for liquidation and as security for National's obligation to the taxpayer under the contract. Only cash transferred to taxpayer or realized out of the assets and property was to be considered as in payment or discharge of National's obligation. (R. 94, 96.)

The taxpayer was to proceed with the liquidation promptly, applying the net proceeds of collection upon National's indebtedness under the contract. It was provided that within 90 days after July 19, 1934, or within a period as extended by agreement of the parties, a final settlement in accounting would be made between the parties under which, if the charges to tax-

payer exceeded its credits, taxpayer was to transfer all remaining assets to National, while if the credits exceeded the charges, National was obligated to pay the difference. If the latter could not do so, all remaining assets might be foreclosed and sold. (R. 96-97.)

In accordance with the contract, taxpayer acquired all the assets and business of National including good will and proceeded to liquidate National. With this acquisition, it became the sole and dominating factor in the banking business in the Ensley locality. (R. 97.)

An examination of the affairs of National made by a vice-president of the First National Bank of Birmingham as of July 18, 1932, indicated that, without considering good will items, National was insolvent. At that time, \$200,000 face value of stock of National was outstanding but the value of claims against the stockholders for double liability was not then appraised. (R. 97.) On July 18, 1932, and during the balance of that year, the responsible officers and officials of taxpayer knew, or should have known, that taxpayer would realize a loss on transactions covered by the contract between taxpayer and National insofar as all items of the contract were concerned with the exception of good will items. (R. 107.)

Pursuant to the contract, National gave taxpayer its note as of July 19, 1932, for \$355,080.63 (R. 97.) During the year 1933 taxpayer realized

from assets pledged to it by National the total sum of \$87,271.16, and during the year 1934, the sum of \$73,811.51. These sums were used to pay expenses, prior liens upon the assets, compensation to taxpayer, and to reduce National's obligation to taxpayer under the contract. (R. 103-105.) The last credit on National's note was made on June 1, 1933, reducing that note to \$302,229.44. Proceedings against stockholders of National were not started until July, 1934. In that year, \$35,000 was collected and subsequent to that year, approximately \$15,000 additional was collected. (R. 97-98.)

On August 12, 1934, taxpayer first made a demand on National for the balance of its principal claim as shown by accounting then made. National failed to make payment and taxpayer retained possession of the assets and continued to liquidate. (R. 106.)

On August 26, 1935, the taxpayer sold to the First National Bank of Birmingham, all of its assets, including good will, with certain exceptions not here material. First National assumed all of taxpayer's deposit liability not in excess of \$611,336.87 and paid certain specified cash to taxpayer for retirement of its preferred stock. First National agreed that it would liquidate all of the transferred assets for the benefit of taxpayer's creditors and stockholders. (R. 98.)

In its income and excess profits tax returns for 1933 and 1934, the taxpayer took deductions in

the respective amounts of \$13,039.03 and \$14,-318.03 of the amount due on the note of National on the theory of a debt ascertained to be partially worthless and charged off. These deductions were disallowed by the Commissioner resulting in that part of the deficiencies here in question. (R. 103, 104.) The deficiencies were paid with interest and the taxpayer filed timely claims for refund which the Commissioner rejected. Thereafter, the present suit was instituted to recover the alleged over-payment of tax.² (R. 99-102.)

The District Court held that the taxpayer was not entitled to the claimed deductions for a partially worthless debt (R. 108, 109) and the court below affirmed (R. 174-177).

ARGUMENT

Recovery was sought by the taxpayer in the present case on the ground that it was entitled to deductions in 1933 and 1934 for a debt ascertained to be partially worthless and charged off in each of those years in an amount not less than that deducted. The taxpayer does not question the correctness of the controlling principles of law stated by the court below with respect to that problem. The determination of the question whether taxpayer is entitled to the claimed deduc-

² The deficiencies asserted by the Commissioner, the claims for refund and the suit in the District Court also involved certain other items which are not presented in the petition for certiorari.

tions is one which turns upon the particular facts of this case, and no unsettled principle of law is involved.

We submit that the decisions of the District Court and of the court below, sustaining the Commissioner's denial of the claimed deductions, are correct under the facts of this case, and that there is no reason for this Court to review the question.

The taxpayer urges, however, as the reason why a writ of certiorari should be granted (Pet. 8-9) that the court below affirmed the judgment of the District Court on a ground which was not at issue in the District Court and that that court has thus so far departed from the accepted and usual course of judicial proceedings as to call for an exercise of the power of supervision of this Court. The cases, such as *Helvering v. Wood*, 309 U. S. 344, relied upon by the taxpayer (Pet. 9) in this connection are all clearly distinguishable on their facts.

We submit that the pleadings and other proceedings in this case do not support the taxpayer's contention that the action of the court below was placed upon a ground raised by the court of its own motion and which was not at issue in this case. Moreover, there is nothing in the opinion of the court to indicate that it considered its decision as being placed upon a new ground, or to indicate that the court purported to exercise a power to affirm on facts which were

not at issue. Thus, the decision below presents no principle of importance to warrant review of this Court, nor has there been, under any view of the circumstances, such a failure of justice as to call for the exercise of the supervisory powers of this Court.

In respect to the partial bad debt deductions, the District Court concluded (R. 108-109) that the burden of proof was upon the taxpayer to establish that it was entitled to the deductions and to establish the amounts allowable and the proper year in which the deductions should be taken, and that the taxpayer had failed to carry that burden. The District Court further concluded (R. 109) that the allowance of the partial bad debt deductions was discretionary with the Commissioner of Internal Revenue, that this discretion was reviewable only when it had been abused and that it cannot be said that the Commissioner abused his discretion in disallowing the deductions in this case.

The court below, in its opinion, pointed out (R. 174) that the Commissioner ruled that the deductions claimed for the partially worthless debt were not allowable for the reason, among others, that there was no determination of worthlessness in 1933 and in 1934. The court further said (R. 174):

But the appellee [the United States] contends both that there was no debt, and no ascertainment of partial worthlessness; and

that any loss was one incurred in purchasing the good will and other assets of the Ensley National Bank. The district court appears to have held that the allowance of partial bad debt deductions *are* discretionary with the Commissioner, and that no abuse of discretion was shown, and that general losses in the transaction with Ensley National Bank were not realized till the transaction was finally closed out in 1935, a year not here involved.³

After discussing the applicable rule of law pertaining to the deduction of partially worthless debts and the facts of this case, the court below stated its conclusion that a case had not been made by the taxpayer that the Commissioner had arbitrarily refused the claimed partial bad debt deductions. This was the precise conclusion to

³ In its brief in the Circuit Court of Appeals, the Government contended in part as follows (pp. 19-20):

"We submit, however, that the Commissioner's action was clearly proper in disallowing the deductions for both 1933 and 1934. Under Section 23 (j), Revenue Act of 1932, and Section 23 (k), Revenue Act of 1934 * * *, the Commissioner *may*, if satisfied a debt is recoverable only in part, allow the same in an amount not in excess of the part charged off during the tax year. The Act gives the Commissioner a wide discretion and his actions in refusing the claimed partial debt deductions are not reviewable unless they are so arbitrary and unreasonable as to constitute an abuse of discretion. * * *.

"Here there was no abuse in the Commissioner's discretion because there was no showing that the debt was recoverable only in part. The evidence below does not establish that the debts were in fact uncollectible. * * *"

which the District Court had come. True, in reaching this conclusion, the court below emphasized the failure of the evidence to show clearly that in 1933 or 1934 the assets of National which secured its note held by taxpayer, plus the liabilities of National's stockholders upon their stock, would not eventually pay the note, but this, we submit, was a matter clearly within the scope of the issues in the case.

The burden was unquestionably upon the taxpayer to establish by appropriate allegation and proof that it had, in each of the years 1933 and 1934, ascertained the claimed amount of the debt to have become uncollectible in each of those years. We submit that there is no reasonable ground for the taxpayer's contention that the Government's answer in the District Court relieved the taxpayer of the burden of proving that it had ascertained in each of the taxable years the partial worthlessness of that part of the debt sought to be deducted.

In paragraph 5 of the complaint, the taxpayer alleged (R. 3-4) that at the time it assumed the Ensley National Bank's liabilities, though it considered some loss probable, it expected to recover from the assets pledged and from the stockholders a substantial amount of its claim against the Ensley National Bank and that it did not consider impossible a recovery of the entire amount thereof, but subsequent experience demonstrated that

the Ensley National Bank was hopelessly insolvent at the time of the take-over and that the taxpayer, before the end of 1932, had discovered that a substantial loss on its claim was inevitable. In its original answer filed February 22, 1941 (R. 44, 45), the Government did not deny this allegation. However, in an amendment to the answer filed on June 17, 1944 (R. 50-51) the Government alleged that it did not have sufficient knowledge or information upon which to form a belief as to the truth of these allegations in paragraph 5 of the complaint, and that these allegations were therefore denied.

While paragraph 6 of the Government's answer (R. 46) alleges that any loss taxpayer expected to sustain from the liquidation of the assets of the Ensley National Bank pledged to it was ascertained prior to the year 1933, and while this portion of the answer was not altered in the amendment to the answer filed in 1944, the taxpayer could not, we believe, have been misled by that allegation in view of the Government's denial by its amended answer of the similar allegation which the taxpayer itself had made in the complaint. Moreover, in paragraph 6 of the answer, the Government denied taxpayer's allegation that it had, before the end of 1933, determined the maximum recovery to be expected from the assets of the Ensley National Bank and specifically averred (R. 46) that taxpayer was not entitled,

under the facts and the law, to a deduction of \$13,039.03 from gross income as a debt ascertained to be worthless, and charged off in the year 1933.

With respect to the year 1934, paragraph 7 of the answer (R. 47) specifically denies that the taxpayer ascertained to be worthless in the year 1934 the \$64,138.03 which taxpayer alleged it charged off as a worthless debt owing to it by the Ensley National Bank.

The order on pretrial hearing entered by the District Court (R. 48-49) also states as an issue in this case to which the Government pleaded the general issue, the question whether the taxpayer was entitled to deduct from gross income certain bad debts for 1933 and 1934 as "ascertainment of these amounts as partial loss in the debt of Ensley National Bank" to the taxpayer.

The manner in which the witnesses were examined further negatives any contention that the question of the ascertainment of what recovery might be had from National's stockholders was not within the issues made by the pleadings. Thus, taxpayer's counsel asked the first witness for the taxpayer the question (R. 117):

Would you say it was reasonably establishable at the end of 1933 and at the end of 1934 that the indebtedness of Ensley National Bank to Ensley Bank & Trust Company [taxpayer] could not be collected in full?

The answer to this question was "yes." Upon cross-examination the witness stated (R. 121) that the book value of the assets transferred to the taxpayer in 1932, and which secured the note of \$355,080.63 here in question, was approximately \$971,000 at the time of the transfer, and when asked if he had appraised the value of the claims against National's stockholders or the possibility of collecting from them, the witness stated that he had not at that time.

The next witness for taxpayer was also asked by taxpayer's counsel (R. 132) whether, in his opinion, the indebtedness of National to taxpayer was collectible in full, and the witness answered that in his opinion it was not collectible in full. Upon cross-examination (R. 137), this witness testified that he knew there would be a loss on the assets of National, but that whether it would finally result in a loss to taxpayer was a question of the stockholders' liability, and that he had not gone into the details of the proposition, taking it as a whole. The witness further testified (R. 138) that the condition of the assets continued to change in 1933 and 1934 for the worse, but that in 1935 some of the assets improved and some got worse.

CONCLUSION

The decision below is correct. The case is one turning upon its own particular facts, and no important unsettled principle is involved, nor is

there a conflict of decisions. The case does not call for further review.

Respectfully submitted.

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SEPTEMBER 1946.